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14 July 1980

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Prime Minister
Mr Lankester

Dear Michael,

In your letter of 3 July to Paul Lever about the Prime Minister's recent meeting with British members of the European Democratic Group you asked for a note on the point raised by Mr Hopper about German restrictions on capital movements.

I enclose a note prepared here which gives details of the matter. The restriction which the Germans are still maintaining is a relatively minor one and in any case not something we are tempted to imitate, for the reasons familiar to you which we still see against introducing exchange controls over capital inflows. But we do of course aim to prevent sterling from developing again into a reserve currency by our arrangements for keeping official holdings down to working balances.

The Germans' interpretation of the Capital Movements Directive in this context seems at least questionable; but they would almost certainly be able to get an Article 108 authorisation from the Commission if necessary; and we can see no advantage in our stirring up this particular legal issue either in Brussels or in Bonn.

I am copying this letter (and the attached note) to the recipients of yours.

Yours ever

John Wiggins

A.J. WIGGINS
Principal Private Secretary

GERMAN RESTRICTIONS ON CERTAIN CAPITAL MOVEMENTS

1. While the Germans have no formal system of exchange controls, they have at various times over the last two decades placed restrictions on certain capital inflows, either using the powers in their Foreign Trade and Payments Law of 1961 or making gentlemen's agreements with the commercial banks. Since 1974, controls have been maintained only on the acquisition by non-residents of domestic money market paper (mainly promissory notes) and fixed interest securities with less than a certain period to maturity. The promissory note control is under a gentlemen's agreement. Till February 1980 the maturity "floor" was fixed at 4 years in either case. It was then raised to 5 years for promissory notes, following a committee set up after heavy inflows in September 1979, but in March was reduced in either case to 2 years.

2. The retention of these inflow controls - fairly vestigial compared with the pre-1974 array - probably reflects:

a. The authorities' reluctance to see the deutschemark taking on a greater reserve role;

b. The fact that these short-maturity instruments tend to be specially attractive to currency speculators (because there is less risk of capital loss).

3. On a. above the argument has been that Germany's economic potential is insufficient to support a reserve currency role; that German capital markets are too small in relation to the dollar markets; and that such a role would bring little benefit to Germany with the current account consistently in surplus. More recently, however, Germany has experienced significant outflows of short-term capital augmenting a rapidly growing current account deficit. This led not only to a programme of direct borrowing from abroad but to acquiescence, albeit still reluctant, in a growing reserve role for the deutschemark: "Germany must learn to live with it" said Pohl, President of the Bundesbank. This acquiescence was marked by the reduction of the maturity period to 2 years last March. At international meetings, we have welcomed these developments as both indicating a German willingness to adopt a diversified pattern of current account financing and providing a wider range of portfolio opportunities for OPEC investment managers.

4. On b. above, the Germans no doubt think it prudent not to remove what could be a first line of defence against sudden speculative inflows, and may indeed not regard the March liberalisation as irreversible. In themselves, however, the present restrictions can hardly be very damaging to British interests although they may somewhat inhibit some portfolio management at the margin.

5. The Germans appear to think that these particular restrictions fall outside the area of obligatory liberalisation under the Community's Capital Movements Directives. While the Commission's lawyers are not happy about this view, the Commission have acquiesced without taking a formal position but believing that the German measures are justified.

6. This attitude on the Commission's part, of not quibbling on the technical legal aspects if persuaded of the need for measures on policy grounds, is generally not unwelcome. But inflow, as well as outflow, restrictions which clearly conflict with the obligations in the Directives do legally need authority under Article 108 (or, in a sudden balance of payments crisis, the unilateral Article 109) of the EEC Treaty or, if the capital market's functioning is disturbed, under Article 73 which also provides for unilateral action on grounds of secrecy or urgency.